What lies beneath

Klumpes, Paul John Marcel; Prowle, Malcolm

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WHAT LIES

Lurking under treacherous public spending waters is an iceberg of off-balance sheet costs and other hidden debts. Future generations will have to pick up the tab

Words: **Paul Klumpes** and **Malcolm Prowle**

IN SEPTEMBER 2013, UK public sector net debt stood at £1.2trn. Even with austerity, the government will continue to borrow large sums for many years and this indebtedness figure will rise substantially. Interest will have to be paid for many decades to come and, ultimately, the debt will have to be repaid.

This is not the end of the story. Many would argue that there are major public sector liabilities not shown on government balance sheets. Most significant of these are 'black holes' in public sector final salary pension schemes and liabilities stretching out for decades on Private Finance Initiative (PFI) projects.

The government's attempt to respond to these matters has provoked unrest. A wave of public sector strikes has been stoked by a deep well of discontent about plans to reform public sector pensions. We also see certain NHS trusts, hampered by the legacy of PFI projects initiated in years when there was an expectation of continued growth in funding, faced with large financial deficits. These deficits can only be dealt with by rationalising service provision – a very unpopular task in the eyes of the public who would prefer to see the trusts 'bailed out' by the government.

In all of this, an important factor to be borne in mind is that of inter-generational equity (IGE) or fairness between generations. Many of the so-called 'baby boomers' had the advantage of free university places, a free NHS and a final salary pension scheme. As they get older they will be placing increasing burdens on the health and social care system and extracting pensions well above what they have contributed to the state schemes.

Forget about soaking the rich or squeezing the bankers. It will not happen other than through tokenism. The only people who can pay for this are our children and grandchildren, who face university loans, high mortgage payments and inadequate pensions. So are we being fair to future generations by trying to protect our own benefits?

It is important to explore the concept of inter-generational equity (or inequity) and to try to assess its financial significance. Given that the likely magnitude is very large, we believe that statutory financial reporting in the public sector should incorporate information for stakeholders on the impact on IGE of various public policies.

In many ways, IGE has always been a politically sensitive issue but trends in society (the ageing population) and economic trends (declining growth rates) have brought it to the forefront of debate. The population of most OECD countries is rapidly ageing. This means demand for public services such as health care, pensions and unemployment benefits is likely to increase significantly over time.

Financial systems were traditionally premised on the assumption that economic growth would outweigh

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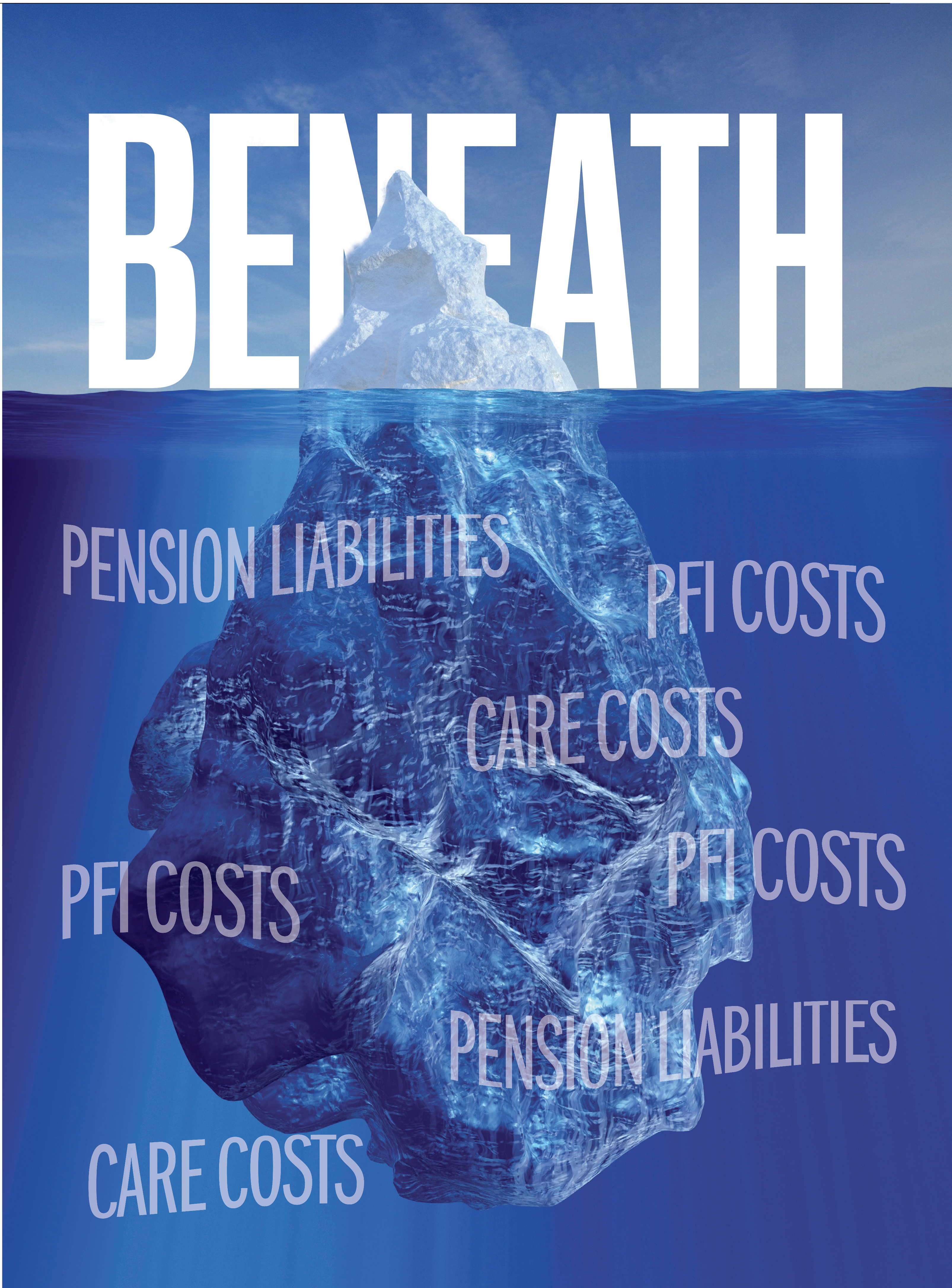
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the growing obligations that derive from an ageing population. This is no longer the case and ageing populations will have significant implications for societies. However, there are now a number of issues that raise concerns about the extent to which IGE is being achieved today.

First, pensions. There are two issues here. The basic state pension in the UK is an unfunded scheme. Payments to today's pensioners are made not from their accrued contributions but from the tax revenues obtained from current taxpayers. Future generations of pensioners will have their pensions paid from the tax revenues from future generations of taxpayers. Raising the pension age (and possibly other changes) will mean that those paying taxes to finance the current generation of pensioners will themselves receive less generous treatment when they reach old age.

Occupational pension schemes in the public sector are largely final salary schemes. A retiree's pension is based on their length of service and salary on retirement. Many public sector pension schemes are now projecting very large actuarial deficits (or black holes) and it is by no means clear how these will be resolved. One possible implication is that the burden of eliminating such deficits will fall, in part, on current generations of taxpayers who, themselves, will not have access to final salary schemes

Second, over the last two decades, a large proportion of capital formation in the UK public sector has been financed by public-private partnerships, most notably through the PFI. The essence of such schemes is that while services derived from the fixed assets produced will be consumed by current citizens from many generations in society, the cost of projects will be spread over 30 years. Thus, in PFI health care projects, much of the benefit will accrue to the elderly but the financing costs will fall on their children and grandchildren.

Public sector financing commitments are also very sensitive to inflation risk via interest rates but the PFI contracts on which many public services rely for capital maintenance are not. Hence, there can be a cash flow mismatch regarding exposure to inflation risk for entities providing these services. This can exacerbate generational inequity among those contributing to or using these services.

THERE MUST BE SERIOUS QUESTIONS ABOUT THE FINANCIAL SUSTAINABILITY OF PUBLIC SERVICES. FUTURE GENERATIONS MAY WELL BE FACED WITH LOWER ACCESS AND STANDARDS OF SERVICE

Third, there is the issue of financial sustainability of public services. Will public authorities have access to sufficient finance to maintain services in the long-term, at their current quality and intensity, for both existing and future generations of customers or claimants?

Public services of various types are made available to citizens by government and are, in turn, financed by the taxes collected from citizens. IGE involves consideration of situations where if one generation is receiving the benefit of government programmes financed by deficit spending and debt accumulation, to what extent does the resulting higher debt impose risks and costs on future generations?

Since the Great Recession in 2008, many countries have followed policies of financial austerity. However, it is still the case that governments are spending more than the revenues they collect and this is being financed by large-scale borrowing, which adds to public debt. Clearly the burden of financing and repaying that debt will fall to future generations.

There must be serious questions about the financial sustainability of public services. Future generations may well be faced with lower access and standards of service, having already paid for the higher standards of services consumed by earlier generations.

All of the above examples of IGE involve a lack of equity for younger generations. However, there are examples that pull in the opposite direction.

For macroeconomic reasons, interest rates in many countries have in recent years been set at historical lows. While this is beneficial to people (generally younger generations) buying houses through low interest mortgages, the burdens of such policies are subsequently borne by older generations who obtain very low rates of interest on their savings. This might be seen as a form of generational inequity against older people.

Nobody really knows the scale of inter-generational equity (or inequity) in the UK. So we have attempted to identify the financial impact of certain trends on IGE. There is no easy way to do this, but a limited analysis has been made concerning two NHS trusts using publicly available data. Both are large acute trusts in England that were involved in the first wave of PFI projects in the late 1990s.

The approach to doing this has been to apply some complex statistical calculations to available public data to calculate (over an 80-year period) the present value of four cash flow streams:

1. projected spending on services to current

Age concerns: Inequity between the generations in consuming and paying for public services is beginning to emerge

generations of service users;

2. projected PFI obligations;

3. projected tax or contribution revenues from current generations of service users;

4. inter-generational equity/inequity (1+2-3).

The results of this exercise suggest inter-generational inequities ranging from £11bn to £19bn in Trust A and £6bn to £15bn in Trust B. While these results are very sensitive to the robustness of key parameters such as inflation and demographic risk, they clearly produce some very large numbers for the magnitude of generational inequity and lack of sustainability.

It is not possible to extrapolate the results of this exercise nationally to identify the scale of IGE in the whole of the NHS, let alone the whole of public services. Nevertheless, the results from just two NHS trusts suggest that, if this were done, the total IGE would be enormous.

Results for the two trusts have been obtained by performing complex calculations well beyond the capabilities of most stakeholders in public sector organisations. Given the likely magnitude of IGE, this raises the question as to whether this information (which politicians may prefer to keep hidden) should be publicly disclosed in the statutory financial accounts of public bodies.

Statutory financial accounts are meant to serve two main purposes for stakeholders:

- A means of delivering stewardship and accountability for the use of public funds in the delivery of public services.
- A means of aiding decision-making concerning public entities.

Criticisms are often made about the limited relevance and usefulness of current public sector financial reporting frameworks for either of the above purposes. We believe such usefulness and relevance might be enhanced by incorporating into these frameworks information about the level of IGE and the future financial sustainability of public services.

Going beyond traditional accruals-based accounting to report on inter-generational equity would demonstrate the importance of distributional aspects of wealth creation in understanding the impact of politically determined funding decisions on financial sustainability. This contrasts with current accounting practice, whereby a net surplus or deficit is simply deduced as some 'residual' of a set of measured and identifiable assets and liabilities and other provisions, allocated or accrued to specific accounting periods.

Furthermore, a generational perspective would inform longer-term financial planning involving various contributors and beneficiaries, both now and in the future. In contrast, traditional accruals accounting is primarily oriented towards today's stakeholders and provides a stewardship report on current and past use of resources.

Unfortunately there is no generally accepted concept of sustainability underlying either the conceptual basis for or practices in public sector financial accounts. Although some commentators recognise that the objectives of public sector financial reporting and accountability of public sector organisations should be wider than that applicable to the private sector, the notion of entity accountability has not made any conceptual link to intergenerational equity and its reporting implications.

We would like to stimulate debate into the desirability of such an approach and the way in which it should be undertaken.

Paul Klumpes *is professor of risk accounting and finance and* ***Malcolm Prowle*** *is professor of business performance, both at Nottingham Business School, Nottingham Trent University*

Photos: **Alamy**